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IPAMS

Independent Petroleum Association of Mountain States

September 19, 1997

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RECEIVED

Mr. David S. Guzy
Chief, Rules and Publications Staff
Royalty Management Program
Minerals Management Service
P. O. Box 25165, MS 3101
Denver, CO 80225-0165

RE: Amendments to Gas Valuation Regulations for Federal Leases
62 FR 19536, April 22, 1997

Dear Mr. Guzy:

The Independent Petroleum Association of Mountain States (IPAMS) submits comments on the above-referenced notice withdrawing the concensus proposed rule of November 6, 1995 (60 FR 56007) and requesting comments on additional proposals for valuing gas produced from federal leases.

In withdrawing the concensus proposed rule which was developed by the Federal Gas Valuation Negotiated Rulemaking Committee (Reg-Neg Committee), MMS has instead proposed two new valuation options. The first is an index price plus or minus an "X-factor" that would account for the difference between the average index value in the zone (as described in the concensus proposed rule) and the average arm's-length gross proceeds received by payors paying on index in the zone.

The second option is based on a "norm" price to be determined by a pricing board established by the Department of the Interior. The pricing board would decide the price based on "spot market indicators, realized prices for external sales, and company evaluations and recommendations".

The Ability to Pay on Gross Proceeds Must Be Retained

IPAMS is opposed to both of the proposed options. To IPAMS' dismay, nowhere in the notice is any mention whatsoever made of retaining the ability to pay royalties based on gross proceeds.

As you well know, IPAMS has held the longstanding position that any valuation methodology that moves the point of valuation away from the lease is unacceptable. IPAMS believes the proper valuation for arm's-length transactions is the gross proceeds received for the production. For non-arm's-length sales, IPAMS believes appropriate benchmarks based on comparable sales in the same field or area must be utilized before imposing an indexed price for valuing production, **unless** it is an **option** for the lessee to use a method other than gross proceeds.

During negotiations on the concensus proposed rule, IPAMS and other trade associations representing the interests of small independent producers insisted that the ability to pay royalties on gross proceeds be included in the concensus proposed rule. As a result, the Final Report of the Federal Gas Valuation Negotiated Rulemaking Committee (Report) states on page 9:

> "Value of gas sold under arm's-length contracts must be based on gross proceeds. ...For gross proceeds-based valuation, value will not be based on the higher of gross proceeds or index.
>
> "...Where there is no active spot market or valid published indices, value must be based on the existing benchmark system or whatever replaces the benchmark system."

The Report goes on to state on page 12:

> "Generally, small independents, States and MMS favored a valuation method based on actual proceeds received from an arm's-length sale of production. Small independents favor gross proceeds for royalty valuation for three key reasons:
>
> 1. Gross proceeds represents actual value received,
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> 2. Gross proceeds does not impose a significant administrative burden on some smaller companies that sell gas at or near the wellhead as it does on larger companies which have multiple marketing arrangements and transactions, and
>
> 3. Royalties have historically been due on gross proceeds.

> "...For MMS and the States, gross proceeds at or near the lease have always been the primary benchmark of market value under the regulations. The Interior Board of Land Appeals (IBLA) and the courts have long upheld gross proceeds in valuing production."

It should be noted that even the major oil and gas companies and larger independents agreed that gross proceeds should be the foundation for valuing production, despite the fact that they preferred an index based method to the complexity of calculating gross proceeds in today's natural gas market. It was this concensus on gross proceeds that persuaded the independents' representatives to vote in favor of the index proposal. Moreover, IPAMS would like to clarify that the concensus was that producers would not be required to pay on the higher of gross proceeds or **any other** valuation methodology for arm's-length transactions.

Problems with MMS' Proposed Options and Cost-Benefit Analysis

Notwithstanding IPAMS' opposition to the proposed options, we would like to comment briefly on the two proposed options and the cost-benefit analysis performed by MMS on the concensus proposed rule.

The index plus or minus method amounts to reviving the issue of looking to an affiliate's resale value, with a 100% true up. Further, using an index plus or minus method for valuing natural gas production will likely lead to establishing an artificial price for gas that does not exist, and could result in small independent producers having to pay royalties on a value that is higher than what they received for their production. Moreover, as explained to industry at the meeting with MMS on July 1, 1997, only arm's-length dedicated sales could be valued using gross proceeds. However, we would like to remind MMS that the concensus proposed rule allowed producers with arm's-length non-dedicated sales to choose between gross proceeds and an index price.

The norm pricing method is fraught with problems. As discussed with MMS at the meeting on July 1, 1997, you cannot compare production and sales in the United States to those in Norway. Vast discrepancies exist between the two countries in terms of the volumes produced, different grades of production, the number of producers, the number of leases, the point of market, and the size and market clout of the majority of producers. Absent the ability to pay royalties on gross proceeds, this method would undoubtedly result in small independent producers having to pay royalties on a higher price than that received. In addition, IPAMS members have serious misgivings about the government establishing the price for a 1/8 share of production, primarily because it is a directly interested party. It would be inappropriate for the government to be involved in establishing the basis for determining its own revenues.

These two options fly straight in the face of Congressional mandate as set forth in the Notice to Lessees Act of 1987, which recognizes that prices received under contracts which are reflective of values in the field or area of production are the best determinant of value for royalty purposes. Moreover, Congress acknowledged that market conditions are the most reliable value for royalty purposes. It is impractical and unfair to impose values which bear no relationship to the actual value of production in fields where there is an established market.

IPAMS believes the cost-benefit analysis performed by MMS is fatally flawed. Among other problems, (1) MMS used weighted averages; (2) index prices were compared to the gross proceeds prices received by "assumed" index payors but were not compared to other gross proceeds payors' prices; (3) MMS used actual transportation rates taken as allowances adjusted for Btu content, but failed to account for variances in Btu content and differentials; (4) MMS did not analyze processed gas even though approximately 50% of OCS production is processed; and (5) no margin of error was applied to the analysis.

It is difficult to comprehend how MMS could lose as much money as is estimated by the cost-benefit analysis. IPAMS acknowledges MMS would be required to determine the safety net median value within two years, necessitating (in MMS' opinion) the presumably costly and time-consuming audit of gross proceeds payors. However, the reduced administrative burden in not having to audit index payors for value and the tremendous savings that would be realized by not having to defend appeals and litigation would offset if not negate any cost of auditing gross proceeds payors. As discussed during the Reg-Neg Committee's deliberations, audits of gross proceeds payors for purposes of determining the safety net would not have to be extensive, nor would each and every payor have to be audited. Of course, this assumes a cost-benefit analysis or threshold would be applied to the need to audit small volumes and *de minimus* dollar amounts.

Concepts Which Should Be Included in Future Gas Valuation Regulations

There were a number of concepts which were unanimously agreed to by the Reg-Neg Committee and which IPAMS believes should be incorporated in any future gas valuation rulemaking.

IPAMS recommends retaining the definition of compression found on page 72 of the Report:

> "Any compression downstream of the facility measurement point (FMP) is deductible as a component of the transportation allowance or the LD [location differential]."

This definition will facilitate the calculation of gross proceeds, and we understand it will be incorporated in the MMS' final rulemaking on transportation allowances.

Further, IPAMS supports the ability to pay on takes for agreements with 100% federal leases with the same royalty rate and funds distribution. IPAMS believes **all** royalty should be paid on takes. IPAMS was and continues to be opposed to any entitlements based reporting because we feel it unfairly discriminates and penalizes small independent producers by forcing them to pay royalties on phantom income.

During negotiations on the concensus proposed rule, there was support from some segments of the industry for entitlements based reporting, but this was only because of the position MMS took in publishing its proposed rule on payor liability (60 FR 30492, June 9, 1995). Now that the payor liability issue has been resolved by the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (FOGRSFA), IPAMS would urge reconsideration of the takes vs. entitlements issue. However, in the event agreement cannot be reached, IPAMS would urge MMS to consider an expanded exception for small independent producers to report and pay on takes from federal agreements with different lessors, royalty rates and/or funds distribution. IPAMS would be willing to meet with MMS to discuss the parameters for such an exception. IPAMS also supports the provision that all lessees in an agreement may contractually agree to assign reporting and payment responsibilities in any manner which ensures that entitled royalty volumes allocable to federal leases are reported and paid each month.

IPAMS would also urge retention of the ability of gross proceeds payors to use transportation factors pursuant to 30 CFR 206.157(a)(5), which states:

> "Where an arm's-length sales contract price or a posted price includes a provision whereby the listed price is reduced by a transportation factor, MMS will not consider the transportation factor to be a transportation allowance. The transportation factor may be used in determining the lessee's gross proceeds for the sale of the product. The transportation factor may not exceed 50 percent of the base price of the product without MMS approval."

IPAMS supports eliminating the need to file transportation and processing allowance forms and the requirement for dual accounting on federal leases.

IPAMS would also urge retention of the option to choose between gross proceeds and an index methodology for arm's-length non-dedicated transactions.

Unified Industry Proposal Still a Viable Option

Following publication of the concensus proposed rule, MMS received negative comments from small independent producers, including IPAMS, and the states. In an effort to address these concerns, MMS published an additional five options for valuation (61 FR 25421, May 21, 1996). Four of the five options proposed by MMS bore little resemblance to the concensus proposed rule. Furthermore, these options failed to address the concerns of the small independent producers and, rather, shifted closer to the position of the relatively few state commentors.

In response to MMS' proposed options, a coalition comprised of industry participants on the Reg-Neg Committee and other interested industry representatives drafted a unified industry proposal which was remarkable in that it was supported by virtually the entire industry – majors and independents, large and small. A copy of that proposal is attached. The unified industry proposal addressed each of the concerns expressed in comments on the concensus proposed rule, **including** the legitimate concerns of the small independent producers.

In our letter of August 19, 1996, commenting on the additional options for valuing natural gas, IPAMS set forth five principles which we still hold must be incorporated in any valuation rule in order to gain the support of IPAMS members. These principles are:

1. The royalty valuation point must remain at or near the lease consistent with statutory provisions.

2. An alternative gas valuation methodology must be preserved. At the same time, the methodology must be simple enough to be utilized by all lessees who qualify.

3. Some royalty-related issues, such as gross proceeds, affiliated sales, gas contract settlements, and deductible transportation costs after FERC Order 636, are the subject of legal disputes. A negotiation should not require that either party fully concede on a disputed legal issue. IPAMS will not agree in a negotiated rule to concede on legal positions we have articulated in good faith, nor do we expect MMS or the states to do so.

4. An exception to entitlements must be meaningful. This issue has been addressed by FOGRSFA and regulations should be consistent with the Act.

5. A true-up of index payments is acceptable as a means of addressing concerns about revenue neutrality and market value; however, the safety net calculation should not

require an audit of gross proceeds payments beyond the existing standard procedures of MMS. Further, the true-up should not be based on an index payor's own gross proceeds or its affiliate's downstream proceeds.

Finally, IPAMS must express our disappointment with MMS' wholesale withdrawal of the concensus proposed rule. As noted above, there are many concepts embodied in the proposed rule on which there was agreement by all Reg-Neg Committee participants and which we believe are important and essential to any valuation rulemaking. It is unfortunate that the cost in time, travel, and lodging expenses could be so callously disregarded by MMS. It is even more offensive that MMS would propose options that clearly incorporate the elements of the negotiated rule to which industry most strenuously objected, specifically, options which fail to discuss or even allude to the ability to pay on gross proceeds. MMS' two newest proposed options still fail to address industry's concerns with current regulations as well as with the earlier proposed options to the concensus proposed rule.

IPAMS still supports the unified industry proposal, including the additional alternatives agreed to by industry at the June 1996 reconvening of the Reg-Neg Committee. The unified industry proposal meets the royalty accounting principles established by the Reg-Neg Committee as well as those principles prescribed by IPAMS. Moreover, and most importantly, the unified industry proposal simplifies the methodology for calculating royalties on gas production without shifting the audit burden to gross proceeds payors while preserving a meaningful exception for takes based reporting.

MMS has spent almost four years in discussion, deliberation and negotiation trying to develop a method for valuing natural gas production. Moreover, the provisions of FOGRSFA have resolved some of the issues of concern expressed by industry Reg-Neg Committee participants. IPAMS believes MMS has the knowledge and the ability to draft valuation regulations that incorporate the principles agreed to by the Reg-Neg Committee as well as those submitted by IPAMS. IPAMS also believes failure to publish a final gas valuation rule essentially as it was negotiated will further erode confidence in the credibility of the Department of the Interior and will obviate participation by industry in any future negotiated rulemaking.

As always, IPAMS appreciates the opportunity to comment on these options. Please do not hesitate to contact me if you would like to discuss any aspect of our comments.

Sincerely,

Carla Wilson

Carla J. Wilson
Director of Tax and Royalty

Attachment

UNIFIED INDUSTRY PROPOSAL

Retain the Committee's index-based method but simplify the rule as follows:

1. Write the final rule in plain English.

2. Include a provision for takes basis reporting for 100% Federal agreements and stand-alone leases. Also, an exception would be provided to pay on other methods when all of the parties agree as specified in the Committee Report.

3. For mixed agreements reporting, the exception would be expanded to an average of 500 barrels of oil per month per well or 3,000 MCF per month per well, or combination thereof[1], determined by dividing the average daily production from all wells on a lease by the number of such wells. For the producer who pays on a takes basis, the time period to reconcile to entitlements would be extended to two (2) years. For adjustments to entitlement based payments, reciprocal interest would apply to the amount of the adjustment, i.e., the producer pays interest when adjustments are made for undertakes and the MMS pays interest when adjustments are made for overtakes. Interest would not begin to accrue on the adjustment amount until the first month following the two year period.

4. Delete the second sentence in proposed 30 CFR 202.450(b) which otherwise would deny royalty-free use of gas downstream of the FMP.

5. MMS would issue separate guidance on the reporting of gas valuation consistent with the recommendations of the Royalty Policy Committee's Subcommittee on Royalty Reporting and Production Accounting.

6. The Index Pricing Point would be determined by using any single valid publication. The producer would select the single valid publication on a zone-by-zone basis at the beginning of every year.

7. Index would be applied to the wellhead MMBtu less a location differential to the appropriate Index Pricing Point. There would be no option to value residue gas on index. For split connects or multiple connections the producer would use either a weighted average or an arithmetic average of the published indices from any single valid publication less the applicable location differential. Refer to the Committee Report, Index Pricing Point (IPP) on page 18. After the first option, Weighted Average, replace the second option as follows:

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[1] This exception would be on a per well basis for both production and injection wells.

<u>2. An arithmetic average of all the physical connections based on the single valid publication.</u>

8. Gross proceeds payors would have the option for all Federal leases inside or outside an index zone, on an annual basis, to elect to apply a gross proceeds based gas value to the wellhead MMBtu less applicable transportation with no safety net. Producers would still pay on gross proceeds on arm's-length dedicated contracts.

9. For all arm's-length and/or jurisdictional transportation, the location differential would parallel the Index Pricing Point valuation methodology. For transportation that is both non-arm's-length and non-jurisdictional, the producer would use the Committee's recommendation. The *de minimis* transportation rate would apply to both gross proceeds and index payors and would not require prior MMS approval.

10. Retain the Committee's recommendations concerning the distinction between transportation and gathering.

11. In order to relieve those paying on gross proceeds from a higher audit burden and relieve the MMS of the administrative burden of auditing the gross proceeds MMS-2014's prior to calculating the safety net, the MMS would calculate the safety net price using only unaudited gross proceeds as reported on MMS-2014's, including any out of period adjustments, but only for the index year for which the safety net is being calculated. The index payors would true up to 75% of the difference between the index payor's weighted average index based value and the median price for unaudited gross proceeds on a zone-by-zone basis. Any safety net adjustment required as a result of any comparison would be accomplished by a one line entry on a zone-by-zone basis. The alternative valuation method would not shift the audit burden to the gross proceeds payors.

12. If the safety net is not published within one (1) year following the end of the index year, then no additional royalty would be due and the index would become the final safety net.

13. Any royalties paid for gas contract settlements proceeds would not be considered gross proceeds for safety net calculation purposes.

14. Gross proceeds payors would be allowed to value small volumes of gas sold non-arm's-length in accordance with its arm's-length transactions and would not be required to use index pricing.